



SENATE BILL 786: Energy Modernization Act

2013-2014 General Assembly

Committee:	House Finance	Date:	May 28, 2014
Introduced by:	Sens. Rucho, Newton, Brock	Prepared by:	Jennifer McGinnis and Heather Fennell, Staff Attorneys
Analysis of:	Fourth Edition		Jennifer Mundt, Legislative Analyst

SUMMARY: The 3rd Edition of Senate Bill 786 does the following:

PART I. EXTENSION OF RULE DEVELOPMENT DEADLINE

SECTION 1 of the bill would extend the rule development deadline to January 1, 2015. Under current law, Section 2(m) of S.L. 2012-143 requires the Mining and Energy Commission (MEC) to adopt rules for a modern regulatory program for the management of oil and gas, including the use of hydraulic fracturing for that purpose by October. 1, 2014.

PART II. EXEMPTIONS FROM THE ADMINISTRATIVE PROCEDURE ACT (APA)

SECTION 2.(a) of the bill would modify a provision in the APA that requires that rules be adopted by the Rules Review Commission (RRC) 25 days before the start of a legislative session in order to be eligible for legislative review during that session. The bill would eliminate the 25 day requirement, as it applies to rules for the management of oil and gas, thus making such rules eligible for legislative review no matter when approved, including if they are approved while a session is underway.

SECTION 2.(b) of the bill would modify a provision in the APA that provides that a legislator may introduce a bill during the first 30 legislative days of any regular session to disapprove a rule that has been approved by the RRC. The bill would change the time allowed to file a disapproval bill from 30 legislative days to 30 calendar days. The language allows for the circumstance in which the rules are approved while session is underway (and at that point become subject to legislative review).

SECTION 2.(c) of the bill would modify a provision under the APA that governs filing of disapproval bills in connection with the legislative review process for rules. Specifically, the APA provides that if a disapproval bill is filed in connection with a rule or suite of rules, the rule(s) cannot become effective until the earlier of either: (i) the day an unfavorable final action is taken on a disapproval bill, or (ii) the day that session adjourns without ratifying a disapproval bill.

The bill would provide instead that rules for the management of oil and gas would become effective on the earlier of: (i) the 31st calendar day of a regular session that begins after the date the RRC approved the rule if a bill that specifically disapproves the rule has not been introduced in either house of the General Assembly by that date; or, (ii) if a bill that specifically disapproves the rule is introduced in either house of the General Assembly before the 31st calendar day of that session, the rule becomes effective on the earlier of either the day an unfavorable final action is taken on the bill, or the 61st calendar day of the session if by that date a bill that specifically disapproves the rule has not been ratified. The language allows for the circumstance in which the rules are approved while session is underway (and at that point become subject to legislative review).



Senate Bill 786

Page 2

SECTION 2.(d) of the bill would modify a provision under the APA that provides that rules received by the 20th day of a month must be reviewed by the RRC by the "last day of the second subsequent month." Instead, the bill would provide that the RRC must review any rule for the management of oil and gas submitted to it by the end of a month by the last day of the next month (thereby potentially expediting review by a month).

SECTION 2.(e) of the bill would exempt the rules for the management of oil and gas from the limitations under the APA that govern certain environmental rules.

SECTION 2.(f) of the bill would modify a provision enacted in 2013 that exempted rules for the management of oil and gas from any requirements under the APA to prepare fiscal notes to provide that the fiscal note exemption for such rules may operate until the provision sunsets on December 31, 2017.

SECTION 2.(g) of the bill would exempt rules for the management of oil and gas from any requirements under the APA that require that a certification be obtained from the Office of State Budget and Management (OSBM), and any requirement for preliminary review of the rules by OSBM.

PART III. DATE CERTAIN FOR ISSUANCE OF PERMITS TO JULY 1, 2015

SECTION 3.(a) of the bill would authorize the Department of Environment and Natural Resources (DENR) and MEC to issue permits for oil and gas exploration, development, and production activities using horizontal drilling and hydraulic fracturing treatments after the 61st calendar day following the date that all rules adopted for a modern regulatory program for the management of oil and gas, including the use of hydraulic fracturing for that purpose, have become effective.

SECTION 3.(b) of the bill would repeal Section 3(d) of S.L. 2012-143 (S820), which prohibited the issuance of permits for oil and gas exploration and development activities using the processes of horizontal drilling and hydraulic fracturing in the State until the General Assembly took legislative action to allow the issuance of such permits, in order to allow the Mining and Energy Commission to create a modern regulatory program to govern all aspects of such activities.

SECTION 3.(c) of the bill would repeal Section 1(c) of S.L. 2013-365 (S76), which amended the moratorium on issuance of permits for oil and gas exploration and development activities enacted by Section 3(d) of S.L. 2012-143 (S820), to prohibit issuance of permits until: (i) all rules required to be adopted by MEC, the Environmental Management Commission, and the Commission for Public Health pursuant to S.L. 2012-143 (S820) have become effective and (ii) the General Assembly takes affirmative legislative action, including repeal of Section 3(d) of S.L. 2012-143 (S820), to allow the issuance of such permits.

PART IV. CREATE OIL AND GAS COMMISSION AND RECONSTITUTE MINING COMMISSION

SECTIONS 4, 5, and 6 of the bill would, effective July 31, 2015, reinstate the Mining Commission (to consist of 7 members) and establish the Oil and Gas Commission (to consist of 9 members) as separate entities. The terms of all members serving on MEC would expire on July 31, 2015, and new appointments to the two distinct commissions would be required by August 1, 2015.

PART V. MISCELLANEOUS STATUTORY CHANGES RELATED TO SHALE GAS EXPLORATION, DEVELOPMENT, AND PRODUCTION

SECTION 7 of the bill would: (i) eliminate two references in the statutes concerning MEC's authority to require operation of wells with efficient gas oil ratios, based upon information that the language

Senate Bill 786

Page 3

is antiquated and does not readily adapt to unconventional oil and gas wells such as those found in the Triassic basin; and (ii) provide that that entry of rules in the North Carolina Administrative Code that address areas identified in subsections (a) and (a3) of G.S. 113-391 by July 1, 2015, create a rebuttable presumption that the rules are sufficient to meet the requirements for development of a modern regulatory program pursuant to that section of the General Statutes.

SECTION 8 of the bill would clarify requirements applicable to trade secrets received in connection with permitted oil and gas activities. Specifically, the provision would explicitly require: (i) MEC and DENR to retain trade secret information received; (ii) provision of the information to the Division of Emergency Management; and (iii) immediate disclosure of the information to first responders and medical personnel in the event of an emergency. The bill also requires the State Geologist, or the Geologist's designee, to review confidential information that concerns hydraulic fracturing fluid to ensure compliance with all State and federal laws, rules, and regulations concerning prohibited chemicals or constituents, or exceedances of standards for chemicals or constituents. The State Geologist, or the Geologist's designee must: (i) issue a written certification within five days of completion of the review that the hydraulic fracturing fluids, including chemicals and constituents contained therein, comply with all State and federal laws, rules, and regulations; (ii) transmit the certification to MEC and the Director of the Division of Energy, Mining, and Land Resources; and (iii) transmit a copy of the certification electronically to the permittee. Horizontal drilling and hydraulic fracturing treatments could not commence until this written certification has been issued and transmitted as required. The State Geologist would also be required to review, in consultation with the State Health Director, confidential information that concerns hydraulic fracturing fluid, and advise local health departments of additional parameters that should be included in testing for private drinking water wells in their jurisdictions in compliance with the requirements of the Private Well Water Education Act enacted in 2012. Unlawful disclosure of information in violation of the provision would constitute a Class 1 misdemeanor¹. Appeals of decisions concerning trade secrets would be directed to the Business Court.

SECTION 9 of the bill would repeal a provision in the statutes that requires State involvement regarding an owner's request for a survey. Specifically, current law reads as follows:

"(6) To require surveys upon application of any owner who has reason to believe that a well has been unlawfully drilled by another person into land of the owner without permission. In the event such surveys are required, the costs thereof shall be borne by the owner making the request."

SECTION 10 of the bill would repeal a provision in the statutes that requires each well to be drilled in the center of a drilling unit, based upon information that the language does not readily adapt to unconventional oil and gas wells such as those found in the Triassic basin.

SECTION 11 of the bill would reduce the fee due upon application to drill, from \$3,000 for each well drilled, to \$3,000 for a first well on a pad and \$1,500 for each additional well on the same pad.

SECTION 12 of the bill would amend a provision in existing law that requires oil and gas operators to provide surface owners with advance notice prior to entry to property (14 days for non-land disturbing; 30 days for land-disturbing), to add language requiring notice to subsurface owners as well (30 days for initiation of exploration, development, and production activities).

SECTION 13 of the bill would:

¹ Assuming no prior convictions the presumptive minimum sentence for a Class 1 misdemeanor is 1-45 days community punishment. The disposition may range from supervised or unsupervised probation, community service, restitution, or fines. The amount of the fine would be in the discretion of the court.

Senate Bill 786

Page 4

- Amend a provision enacted in 2011 that established an oil and gas operator's presumptive liability for contamination of water supplies located within 5,000 feet of a wellhead, to change the distance to water supplies located within a ½ mile radius of a wellhead.
- Amend a provision enacted in 2011 that required an oil and gas operator or DENR to conduct one pre-drilling test of water supplies within 5,000 feet of a wellhead, and two post-drilling tests within 24 months after drilling has commenced. The bill would change:
 - The required distance to a ½ mile radius
 - The number of required tests to 5, which must be conducted at 6-months, 12-months, 18-months, and 24-months after production has commenced (in addition to the pre-drill test conducted 30 days prior to commencement of drilling)
 - Require that an independent third party from a DENR-approved list conduct the sampling (with the costs of testing still reimbursed by the operator)
 - Explicitly state that an operator must provide the results of any testing conducted within 30 days of sampling to DENR, and allow operators to share results of testing with other operators
 - Designate the results of testing as a public record and require DENR to post any results to DENR's website within 30 days of receipt of the result
- Require an operator to provide a bond running to the State sufficient to cover any potential environmental damage caused by the drilling process in an amount no less than \$1,000,000, which may be increased if MEC determines that the drilling operation would be proposed to be sited in an environmentally sensitive area.
- Specify that actions for recovery of cleanup costs, damages, or for civil penalties may be brought against any of the persons having control over the activities that contributed to the contamination, damage to property, or other violations, and provides that such persons would be jointly and severally liable, with ultimate liability between the parties determined by common-law principles.

SECTION 14 of the bill would invalidate local ordinances that prohibit or have the effect of prohibiting oil and gas exploration, development, and production activities (including, those that would impose taxes, fees, or charges, or that regulate health, environment, or land use). The provision mirrors a statute preempting local government regulation of hazardous waste facilities (G.S. 130A-293). Specifically, the bill would invalidate ordinances that:

- Prohibit the siting of wells for oil and gas exploration, development, and production within any county, city, or other political subdivision.
- Prohibit the use of horizontal drilling or hydraulic fracturing for the purpose of oil or gas exploration or development within any county, city, or other political subdivision.
- Place any restriction or condition not placed by the statutes governing oil and gas upon oil and gas exploration, development, and production activities and use of horizontal drilling or hydraulic fracturing for that purpose within any county, city, or other political subdivision.
- In any manner are in conflict or inconsistent with the provisions of the statutes governing oil and gas.

SECTION 15 of the bill would:

- Require that all natural gas compressor stations associated with an oil and gas drilling operation be located inside a baffled building.
- Include a provision in the statutes governing oil and gas that prohibits the injection of wastes produced in connection with oil and gas exploration, development, and production, and use of horizontal drilling and hydraulic fracturing treatments to subsurface or groundwaters of the State by means of wells. Note that this is prohibited in another Chapter of the General Statutes, and is also prohibited under a draft rule pending with MEC.

Senate Bill 786

Page 5

- Provide that DENR shall conduct an environmental compliance review of each applicant for a new permit for oil and gas activities in order to determine the extent to which the applicant, or affiliated entity, has substantially complied with the requirements applicable to any activity in which any of these entities previously engaged, and has substantially complied with federal, North Carolina, and other states' laws, regulations, and rules for the protection of the environment. DENR would be authorized to deny an application for a permit if the applicant has a history of significant or repeated violations of statutes, rules, orders, or permit terms or conditions for the protection of the environment or for the conservation of natural resources as evidenced by civil penalty assessments, administrative or judicial compliance orders, or criminal penalties. DENR would also be authorized to modify or revoke a permit, or require issuance of a new permit, based on substantial changes to environmental compliance history after a permit's issuance.
- Provide that no liability for trespass would arise from activities conducted for the purpose of seismic or geophysical data collection if a person has a landowner's written consent to enter the land for the activities, or if the person conducts seismic and geophysical data collection by undershooting from an off-site location and without physical entry to private land. If such activities are conducted through physical entry to land without a landowner's written consent, the violation would constitute a Class 1 misdemeanor². The language further provides that persons conducting seismic or geophysical data collection are civilly liable for any physical or property damage determined to be a direct result of their seismic or geophysical data collection activities, whether or not the seismic or geophysical data collection was conducted by undershooting the land at an off-site location or by physical entry to land as permitted by the landowner.

SECTION 16 of the bill would exempt persons engaged in activities involving the construction, repair, or abandonment of a well used for the exploration or development of oil or gas from the water well contractor certification requirements under Chapter 87 of the General Statutes.

PART VI. SEVERANCE TAX

SECTIONS 17 THROUGH 19:

The draft proposal would repeal North Carolina's current severance tax and levies a new severance tax on the removal of energy minerals from the soil and water of the State. The current State severance tax was enacted in 1945 and has not been modified since 1973. The current tax is five mills on each barrel of oil (the equivalent of .5¢ per barrel of oil) and one-half mill on each 1000 cubic feet of gas (the equivalent of .05¢ per 1000 cubic feet of gas). No tax is collected under the current law. The new severance tax would add condensates to the tax base, raise the tax rate on oil, and create a floating tax rate for gas.

Energy minerals are defined in the bill to include all forms of natural gas, oil, and related condensates. Thirty-three states, including North Carolina, currently impose some form of severance taxes on the extraction of oil and gas. Of the 33 states, 25 states impose a tax as a percentage of the value of the resource extracted, 7 states impose a tax on the volume extracted, and 1 state imposes a tax that is a combination of the two methods.

² Assuming no prior convictions the presumptive minimum sentence for a Class 1 misdemeanor is 1-45 days community punishment. The disposition may range from supervised or unsupervised probation, community service, restitution, or fines. The amount of the fine would be in the discretion of the court.

Senate Bill 786

Page 6

Tax Rate – Marginal gas is the gas produced from a well that is only capable of producing a small amount of gas (no more than 100 MCF of gas). The tax rate for the severance of energy minerals would be as follows:

	2015-2018	2019-2020			2021-2023			2023 and thereafter		
Oil and condensates	2%	3.5%			5%			5%		
Marginal Gas	.4%	.6%			.8%			.8%		
Gas	.9%	Based on <i>delivered to market</i> price per mcf			Based on <i>delivered to market</i> price per mcf			Based on <i>delivered to market</i> price per mcf		
		Over	Up to	Rate	Over	Up to	Rate	Over	Up to	Rate
		-0-	\$3	.9%	-0-	\$3	.9%	-0-	\$3	.9%
		\$3.01	\$4	1.9%	\$3.01	\$4	1.9%	\$3.01	\$4	1.9%
		\$4.01	NA	2.9%	\$4.01	\$5	2.9%	\$4.01	\$5	2.9%
					\$5.01	\$6	3.9%	\$5.01	\$6	3.9%
					\$6.01	\$7	4.9%	\$6.01	\$7	4.9%
					\$7.01	NA	5%	\$7.01	\$8	5.9%
								\$8.01	\$9	6.9%
								\$9.01	\$10	7.9%
								\$10.01	NA	9%

Tax Base – For condensates and oil, is applied to the total actual gross price paid by the first purchaser of the condensate or oil. For gas, the tax rate is applied to the "delivered to market" value of the mineral sold. The "delivered to market value" of gas is the actual gross price paid minus the costs incurred by the producer to get the gas from the mouth of the well to the first purchaser.

Administration – The tax would be the liability of the producer of the gas. The producer is the entity that extracts the mineral from the soil or the water of the State. Returns and taxes are due on either a monthly or quarterly basis, depending on the tax liability of the producer. A bond or letter of credit would be required for producers that fail to file a return or make a payment of tax due.

Permit Suspension – Permits for oil and gas exploration using horizontal drilling or hydraulic fracturing would be suspended for any producer that fails to file a return or make a payment for severance taxes.

No Local Taxes – Local governments would not be authorized to impose any additional taxes on the severance of energy minerals in the State.

Property Taxes – The value of real property attributable to the presence of energy minerals is exempt from taxation where a permit to drill on the property has not been issued.

PART VII. STUDIES

SECTION 20 of the bill would direct the Local Government Division of the Department of Revenue to: (i) study how other states value energy minerals for the purpose of property taxation; and, (ii) establish guidelines for counties to ensure the consistent and fair taxation of energy minerals throughout the State. The Division would report its findings to the Joint Legislative Commission on Energy Policy on or before January 1, 2015.

SECTION 21 of the bill would direct the Joint Legislative Commission on Energy Policy to study how the development of the energy industry will affect the property tax revenues of local governments. The study shall examine how the industry will affect property enrolled in the present use value program, and

Senate Bill 786

Page 7

ways to limit the growth of property tax revenues resulting from increased property valuations due to energy production. The Commission shall report its findings to the 2015 General Assembly.

SECTION 22 of the bill would direct the Department of Commerce, in consultation with DENR, the North Carolina Ports Authority, and the Department of Administration, to study the desirability and feasibility of siting, constructing, and operating a liquefied natural gas (LNG) export terminal in North Carolina. The Department of Commerce would report its findings and recommendations to the Joint Legislative Commission on Energy Policy and the Environmental Review Commission (ERC) on or before January 1, 2015.

SECTION 23 of the bill would direct the Department of Transportation to study: (i) additional statutory authority that may be necessary or advisable for DOT to adequately address energy-related traffic, including authority that pertains to permitting and assessment of fees; (ii) the feasibility or advisability of including any requirements that DOT may recommend to manage energy-related traffic, and resulting impacts, in a coordinated permit in conjunction with requirements of the Department of Environment and Natural Resources, or whether such requirements should be implemented through a separate permitting process; and (iii) performance bonding and other surety mechanisms, including road use agreements, to reclaim and repair any State posted roads that are damaged due to heavy vehicle, equipment, and machinery traffic used in support of and conjunction with horizontal drilling and hydraulic fracturing operations on State posted roads. DOT would report its finding and recommendations, including any legislative proposals, to the Joint Legislative Energy Policy Commission and the Joint Legislative Transportation Oversight Committee on or before January 1, 2015.

SECTION 24 of the bill would direct the State Board of Community Colleges to study the feasibility and desirability of developing a program to prepare students with a general education foundation and technical competencies for employment opportunities in the oil and natural gas drilling, gathering, and field operations industry. Specifically, the State Board would be required to consider developing such a program at one or more of the community colleges located where the potential for shale gas resources is highest and would evaluate similar education programs in community college systems in other states. The State Board would report its findings and recommendations, including any legislative proposals to the Joint Legislative Energy Policy Commission and the Joint Legislative Education Oversight Committee on or before January 1, 2015.

SECTION 25 of the bill would direct DENR to:

- (1) Examine MEC's rules, once adopted, related to oil and gas exploration, including, but not limited to, rules concerning drilling units, spacing requirements, and setbacks, and all rules DENR determines will affect the regulation of compulsory pooling in the State.
- (2) Study, in conjunction with MEC and the Consumer Protection Division of the North Carolina Department of Justice, the issue of amending current dormant mineral statutes regarding extinguishment and other consumer protection issues related to split estates.
- (3) Issue specific recommendations for legislative action related to compulsory pooling and dormant mineral statutes and report the findings of their study, including specific proposals for legislative action, to the Joint Legislative Commission on Energy Policy and the Environmental Review Commission on or before October 1, 2015.

SECTION 26 of the bill would direct MEC and DENR to study the development of midstream infrastructure in North Carolina, which is necessary or advisable to facilitate the exploration, development, and production of the State's oil and gas resources. Infrastructure examined must include development of pipelines, gathering systems, compressor stations, pumping systems, on-site and near-site storage tanks, and natural gas liquids processing systems. MEC would report the findings of this study, including specific

Senate Bill 786

Page 8

proposals for legislative action, to the Joint Legislative Commission on Energy Policy on or before March 1, 2015.

SECTION 27 of the bill would direct the State Energy Office to study and make legislative recommendations on a comprehensive long-range State energy policy to achieve maximum effective management and use of present and future sources of energy. The Office shall study all of the following:

- (1) The long-term environmental and economic impact of base load power generation of electric public utilities.
- (2) The comparison of base load power generation alongside all other forms of energy used for power generation, including renewable and alternative sources of energy, and the environmental and economic impact of all forms of power generation.
- (3) The implementation of S.L. 2007-397, including environmental and economic impacts from the law, and recommendations on any changes to the law as necessary.
- (4) The impact to the electrical grid and to the economy of allowing third-party sales of electricity on the State's military installations.

The State Energy Office shall report its findings to the Joint Legislative Commission on Energy Policy on or before December 1, 2014.

SECTION 28 of the bill would direct the Division of Purchase and Contract in the Department of Administration, in coordination with the Department of Public Instruction, to allow any fuel option to be considered for the award of a school bus contract. DOA and DPI would also be directed to study the infrastructure that would be necessary to support school bus fleets fueled by natural gas and report any findings and recommendations to the Joint Legislative Energy Policy Commission on or before January 1, 2015.

PART VIII. MISCELLANEOUS PROVISIONS UNRELATED TO SHALE GAS

SECTION 29 of the bill would repeal a provision that requires the Energy Policy Council to use an attorney assigned by the AG's office, and instead allow the Council to have legal support provided by DENR.

SECTION 30 of the bill would adopt the gas gallon equivalent (GGE) equivalent for compressed natural gas and the (diesel gas equivalent) DGE equivalent for liquid natural gas for the purpose of motor fuel taxation. The GGE equivalent is 5.66 pounds of compressed natural gas. The DGE equivalent of liquefied natural gas is 6.06 pounds of liquefied natural gas.

PART IX. SEVERABILITY AND EFFECTIVE DATE

SECTION 31 of the bill would provide a severability clause in the event that any section or provision of the act were declared unconstitutional or invalid by the courts, and would provide that the act would be effective when it becomes law (except as otherwise provided).